Regulating the Structure of the EU Banking Sector

Alexander, Kern

DOI: https://doi.org/10.1007/s40804-015-0012-0

Originally published at:
Alexander, Kern (2015). Regulating the Structure of the EU Banking Sector. European Business Organization Law Review, 16(2):227-252.
DOI: https://doi.org/10.1007/s40804-015-0012-0

Eur Bus Org Law Rev (2015) 16:227–253
DOI 10.1007/s40804-015-0012-0

ARTICLE

Regulating the Structure of the EU Banking Sector

Kern Alexander[1]

Published online: 22 July 2015

Abstract The article analyses recent developments in the regulation of the institutional structure of banking groups in the European Union. It discusses the evolution of the universal banking model in Europe and how the global banking crisis of 2007–2009 has led to structural regulatory reforms of the European banking industry. Particular attention is paid to the British banking sector and to the United Kingdom's ring-fence banking legislation and structural regulatory reforms. The article analyses the EU Commission's proposed legislation to regulate the organisational structure of European banks and banking groups and compares it to structural reform legislation in Germany and France. It also analyses some of the main challenges concerning implementation of EU structural banking reforms and whether they can be effectively coordinated with existing bank supervisory and resolution practices. The article concludes by suggesting that the various limitations and prohibitions on bank trading activities in structural regulatory reforms will probably not lead to a reduction of harmful risk-taking in the financial sector, but to a shift of risk-taking away from the banking sector (where it can be monitored) to under-regulated areas of the financial system.

Keywords European Union law · Banking regulation · Bank corporate governance and organisation · Structural banking regulation · European banking law · Universal banking · Ring-fenced banking · Investment banking · Proprietary trading

✉ Kern Alexander
kern.alexander@rwi.uzh.ch

[1] Chair for Banking and Financial Market Law, Faculty of Law, University of Zurich, Raemistrasse 74-22, 8001 Zurich, CH, Switzerland

1 Introduction

'One ring-fence to rule them all and in the darkness bind them'.[1]

The highly regarded universal banking model was called into question after the market turmoil of 2007–2009 when a number of large systemically important European banks and financial groups fell into severe financial difficulties and were either rescued with taxpayer-funded bailouts or supported through central bank funding.[2] The depth of the weaknesses in these institutions and the extent of the taxpayer bailouts and the subsequent adverse impact on the economy and sovereign debt finances have led to a re-evaluation of the benefits of the universal banking model and to calls for structural reform of European banking groups, including proposals to ring-fence or segregate certain banking and trading operations. This article analyses how ring-fencing proposals in Europe will affect the institutional structure of the universal banking group in several EU states. In doing so, it discusses the evolution of universal banking in Europe and its important role in supporting the provision of financial services for the European economy. Second, it analyses the United Kingdom's ring-fencing regime as set forth in the Financial Services (Banking Reform) Act 2013. Third, the article analyses the European Commission's 2014 structural regulation proposal and compares it with similar legislative initiatives in France and Germany. In doing so, it makes reference to the US Volcker Rule's structural requirements under the Dodd-Frank Act 2010.[3] Fourth, the arguments for and against ring-fencing are considered in the context of the UK legislation and the Commission's proposal.

The article then addresses the question of whether structural reform or ring-fencing may hinder the effectiveness of bank resolution regimes and what can be done to enhance coordination between both frameworks. It suggests that ring-fencing proposals may enhance prudential regulation and bank resolution procedures by requiring banking groups to be more transparent in their group structures and protecting the bank's systemic functions from excessive risk-taking. However, it also argues that the effectiveness of a Member State's ring-fence or structural regulation may be undermined by the sweeping powers granted to the Member State resolution authority under the Bank Recovery and Resolution Directive to order a banking group to remove any 'organisational impediments' to its resolvability, even

[1] The Lord of the Rings, as cited in P Green and JC Jennings-Mares, 'Lords of the Ring-Fence: UK Banking Commission publishes its final report', Mondaq, 22 September 2011.

[2] According to IMF estimates, between 2007 and 2010 EU banks incurred crisis-related losses of between €1 trillion or 8 % of EU GDP, and, moreover, the European Commission approved €4.5 trillion (equivalent to 37 % of EU GDP) of state aid measures to EU financial institutions. International Monetary Fund (2010).

[3] The Volcker Rule represents an important part of the US approach to structural regulation as set forth under the Dodd-Frank Act 2010, which was enacted in 2010 after the 2008 financial crisis. See Wall Street Reform and Consumer Protection Act, PL 111–203, 124 Stat 1376 (2010) (the 'Dodd-Frank Act'). The Dodd-Frank Act's preface states as its overriding objective to 'promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes'.

though the banking group has already fully complied with the jurisdiction's ring-fence requirements. This potentially results in a direct conflict between the legal requirements of a Member State's ring-fence law and the power of the Member State resolution authority to impose reorganisation requirements on a banking group to ensure its resolvability. This creates significant legal uncertainty for the banking group and limits the effectiveness of the Member State's structural regulation law. Moreover, other concerns are raised about bank ring-fence laws, including that they may significantly limit the economic benefits of the universal banking model and lead to the most risky trading activity (i.e., proprietary trading, including currency, credit and commodity derivatives) shifting off the bank's balance sheet into the shadow banking sector where it can still pose significant risks to financial stability.

2 The Universal Banking Model in Europe

The universal banking model provides the predominant form of organisational structure for European banks.[4] Universal banking traditionally involved a single bank offering a variety of financial services across the main financial sectors of commercial banking, securities trading, and insurance.[5] Universal banking aims to achieve synergies in the provision of financial services through cross-selling of products and investments and reduced overall risks through diversification.[6] The universal banking model rose to dominance in continental Europe because historically bank loans were the main source of funding for companies, while in the US and UK companies sourced around two-thirds of their funding in capital markets.[7]

Universal banks may engage in an array of financial activities ranging from mortgage lending and credit cards to underwriting and selling securities and insurance.[8] In some jurisdictions, such as Germany, they take equity stakes in non-financial firms and vote their shares to influence management, while often appointing their agents and employees as board members of firms in which they

[4] See Canals (1997), at pp 6–11. A recognised version of the universal banking model in continental Europe is bancassurance, in which the banking corporation is permitted to take deposits, make loans and provide payment services, while also providing insurance services and products. In addition, the *bancassurance* model allows the bank to engage in other financial service activities such as securities and derivatives trading and underwriting. Ibid.

[5] Ibid.

[6] European Central Bank (2005), pp 79–87.

[7] The recent trend in Europe, however, is for companies to source more and more of their funding in capital markets. See European Commission, Communication from the Commission to the European Parliament and the Council on long-term financing of the European economy, Brussels, 27.3.2014 COM(2014) 168 final, at pp 10-12. The Commission aims to propose legislation to enhance long-term financing of the European economy by: (i) mobilising private sources of long-term financing; (ii) making better use of public finance; (iii) developing capital markets; (iv) improving SMEs' access to financing; (v) attracting private finance to infrastructure; and (vi) enhancing the overall environment for sustainable finance.

[8] See Canals (1997), at pp 8–11.

own shares.[9] Hence, they combine commercial banking with investment banking activity, along with corporate governance oversight of the firms they lend to, and provide their clients with a one-stop shop for financial services.

Universal banking can also operate in a corporate group or conglomerate[10] structure by providing a wide range of financial services through a network of companies and firms that are controlled by a holding company or affiliated banking or financial entity.[11] Multi-functional banking and financial groups are usually international in character either through their cross-border operations via foreign subsidiaries and branches or through their interconnections with foreign financial institutions and other market participants via the securitisation markets, securities lending and repurchase agreement (repo) markets, and the derivatives and swaps markets. The growing operations of universal banks in corporate group and conglomerate structures is a response to the globalisation of financial markets and the competitive pressures of providing financial services to corporate clients with cross-border operations, and to the strategy of pooling capital and investment services to achieve greater returns for the bank's own proprietary trading and its secondary trading activity for its clients.[12]

In this regard, these large banking and financial groups are multi-functional in their operations. They provide the entire financial system with liquidity and therefore play a central role for the economy by providing funding to institutions and individuals to invest in viable assets that might otherwise not obtain funding in a difficult economic climate. The array of financial services which they provide can also facilitate and enhance cross-border trade and investment and assist local companies with more competitive terms of finance for their cross-border operations, not to mention the competitive financing arrangements that a large universal bank group can make available for the cross-border operations of a large multinational company.[13]

This highly regarded banking model, however, was called into question because of the global financial crisis of 2007-09. Large financial institutions operating in corporate groups or conglomerate structures expanded their cross-border operations in the 1990s and 2000s in order to compete in foreign markets and to diversify their risk exposures.[14] Most of these institutions utilised risky trading strategies, including complex securitisation structures and synthetic credit default swaps, to

[9] This is the classic operational strategy of large universal banks in Europe and Japan. Indeed, the largest universal banks in terms of asset size (Deutsche Bank $2.73 trillion, HSBC $2.69 trillion, Mitsubishi UFG 2.67 trillion and Credit Agricole $2.58 trillion) use the size and scope of their balance sheets to leverage their trading positions in the derivatives markets and to offer a number of other financial products. See Snider (2013).

[10] See the report of the Tripartite Group of Bank, Securities and Insurance Regulators (1995), at p 1 (defining a 'financial conglomerate' as any corporate group under common control whose exclusive or predominant activities consist of providing a significant level of services in at least two of the financial sectors of banking, securities and insurance). See also, Menoud (2010).

[11] Bentson (1994).

[12] As the Financial Times reported: 'Universal banking for now is an unbeatable model. Globally, the banks that are winning are those that lend, issue cards, provide custody services, issue guarantees and arrange bond placements. We have one client, one relationship, one person answers for them—and there are many products and the synergies are enormous', Financial Times, 2 August 2010.

[13] Eiteman et al. (2004), at pp 696–701.

[14] See Committee on Global Financial System (2012), at p 1, fn 4; Joint Forum (2010), at p 14.

shift risk off their balance sheets into the wholesale securities markets, which, at the time, was viewed as beneficial and promoting a more resilient financial system.[15] This spreading of risk, however, failed to take into account structural risks and linkages in the financial system that could create systemic risks. Moreover, inadequate macro-prudential regulatory and supervisory controls resulted in massive amounts of leverage building up across the financial system and an over-reliance by banks on short-term wholesale funding.[16]

Consequently, in 2007 and 2008, large banks and financial institutions—including many universal banking groups—experienced severe financial distress and were either rescued with taxpayer-funded bailouts or supported with central bank and government guarantees.[17] Large banking groups and conglomerates were criticised for investing in high-risk structured finance assets and for speculating in credit default swaps and other credit-linked derivatives which recklessly increased their risk exposure at the expense of their depositors, creditors, shareholders and, ultimately, the taxpayers.[18] The collapse of these institutions and the extent of the taxpayer bailouts and the subsequent impact on the economy have led to a re-evaluation of the benefits of the universal banking model. It also led to calls for structural regulation of banking groups that would require, among other things, legal separation—or ring-fencing—into a subsidiary of the group's retail deposit-taking and small business lending activities, or alternatively ring-fencing the risky trading activities of a banking group into a separate subsidiary.[19] The Financial Stability Board surveyed the various proposals for structural regulation in a 2014 report to the G20 which addresses the consistency of national efforts to regulate banking structure with the FSB's international regulatory agenda and related issues of cross-border consistency and the implications for global financial stability.[20]

3 Ring-Fenced Banking—the UK Approach

Historically, the organisational structure of British banking evolved differently from the universal banking model of other European states because of legal restrictions on the size and operations of domestic and multi-national banks. In the eighteenth

[15] Brunnermeier et al. (2009), at p 18.

[16] Ibid., at pp 26–27.

[17] See 'Systemrelevante Finanzunternehmen—G20 Sehen Fortschritte bei Nationalen und Internationalen Lösungsansätzen zum "Too Big to Fail" Problem', BaFin Journal, October 2013, p 30. See also Darling (2011), at pp 130–49 (discussing the negotiations and financing arrangements of the British Treasury's bailout of the Royal Bank of Scotland and Lloyds Banking Group).

[18] See BaFin Journal, ibid., at p 31.

[19] See, generally, the Independent Commission on Banking (ICB) (2011), at p 252 (calling for UK banking groups to be required to maintain a 'ring-fence' or subsidiarisation of their retail banking operations). See also High-Level Expert Group on Reforming the Structure of the EU Banking Sector (2012) ('Liikanen Report'), at p 105 (calling for risky trading activities including proprietary trading to be separated from retail banking in a subsidiary of the banking group).

[20] Financial Stability Board (2014).

and nineteenth centuries, the development of banking in England was gradual.[21] Before 1826, banks in England and Wales were not permitted to have more than six partners, except for the Bank of England, whose original charter, granted by Parliament in 1694, had been re-enacted by Parliament time and again on terms that provided it with the sole right among English banks to joint stock organisation status and to have more than six members.[22] The Bank's exclusive privilege to have joint stock organisation status, however, ended in 1826 when Parliament enacted legislation allowing private banks to adopt the joint stock organisation form.[23] In 1844, parliamentary legislation introduced limited liability for joint stock companies, including joint stock banks.[24] Thereafter, the joint stock banking system grew rapidly, far surpassing in number the hundreds of smaller private banks already in existence throughout the country.

By the twentieth century, British banking groups had grown dramatically in size and scope with their cross-border operations in far-flung former colonies.[25] By the late twentieth century, British banking groups, such as Barclays Plc and the Royal Bank of Scotland Plc, had become some of the largest banking groups in the world with their retail banking conducted in separate subsidiaries from their investment banking activities. The synergies brought about by such conglomerations of banking and financial activity contributed to the dramatic growth of the banking sector relative to the rest of the British economy.[26] During the financial crisis, large financial institutions with cross-border operations, such as the Royal Bank of Scotland, Lloyds TSB and Halifax Bank of Scotland, received direct taxpayer bailouts that took the form of equity capital injections by the UK Treasury and central bank guarantees of their liabilities. In 2008, the UK Treasury injected capital directly into the Royal Bank of Scotland Plc (RBS)—one of the world's largest banking groups—and became an 82 per cent owner of RBS in order to prevent its collapse and a major cross-border financial crisis that would have had devastating effects across Europe and globally.[27]

In 2010, the Chancellor of the Exchequer, George Osborne, appointed the Independent Commission on Banking (ICB) to conduct a study on how British banks could be made safer and more competitive while still performing their vital economic functions. The ICB (also known as the Vicker's Commission) issued its report in 2011, making a number of recommendations, the most important of which was that large British banking groups should be institutionally restructured so that

[21] Crick and Wadsworth (1935), Jones (1993), at pp 76–82.

[22] See Clapham (1944), at pp 79–86.

[23] Though it was not until 1834 that banks with joint stock organisation status could be established in London. See Crick and Wadsworth (1935), at p 135.

[24] Joint Stock Companies Act 1844 (7&8 Vic, c 110).

[25] See discussion in Jones (1993), at p 297 (the British multinational bank strategy in Australia in the 1890 s of '[e]stablishing a savings bank was one means whereby the trading bank could, indirectly, secure deposits' to support the bank's trading activities).

[26] See ICB (2011), at p 17. Indeed, the value of the British banking sector exceeds 500 % of the value of British GDP.

[27] The UK Treasury, through the entity UK Financial Investments Ltd, owns 79 % of the shares of the Royal Bank of Scotland and 25 % of the shares of Lloyds Banking Group as of December 2014.

their retail deposit-taking and payment services, along with services for small and medium-sized businesses, would be segregated into a separate body that would be prohibited from engaging in risky trading activities and other investment banking business that would now have to take place in a separate subsidiary of the group.[28] The ICB asserted that separation or 'segregation' of the retail banking operations from the rest of the banking group would make the group easier to resolve in a crisis because the assets and liabilities of the group could be separated from the assets and liabilities of the ring-fenced bank so that the latter could continue to provide vital deposit and payment services for the economy. The ICB argued that for ring-fencing to be effective it was necessary for the barrier separating the retail bank from the group to be high so that state-insured deposits could not cross-subsidise risky trading activity in other entities of the group. This would lead, over time, to a shrinking of the group's risky activities (for example, fixed income derivatives and currency trading) to a more sustainable level that would not, it was argued, pose as much risk to the financial sector. The ICB concluded that ring-fencing would have the overall effect of making large banking organisations easier to resolve while maintaining critical banking services during distressed markets, and limiting excessive risk-taking in other parts of the group that could undermine financial stability.

The UK Government accepted the ICB's ring-fencing proposals by proposing primary legislation in 2012 that received the Queen's assent in 2013 as the Financial Services (Banking Reform) Act 2013.[29] The Banking Reform Act establishes the concepts of ring-fenced bodies and core and excluded activities. The precise details of which banking groups would be subject to the ring-fencing requirement and the definition of core and excluded activities were proposed by the Treasury in secondary legislation made under the Act that was published for consultation in July 2013.[30] The Treasury introduced secondary legislation to Parliament in 2014 that defines ring-fencing to apply to banks with 'core deposits' of £25 billion or more.[31] 'Core' deposits are defined as those of individuals (other than high-net-worth individuals (HNWIs) and their families) and small businesses. HNWIs and larger organisations' depositors will have the option (but not the obligation) to deposit outside the ring-fence if they so choose.[32]

The UK Government asserts a robust ring-fence, that is, structural separation between banking services deemed essential for individuals and small and medium-enterprises (SMEs) and the risky trading activities of investment banks, to be essential for reducing structural complexity and enhancing the resolvability of banking groups in a crisis or other distressed scenario, where speed of execution is

[28] The ICB also proposed that banks create more efficient account transfer services that would allow customers to change accounts between banks, thereby enhancing competition in the retail banking sector.

[29] Financial Services (Banking Reform) Act 2013, available at http://www.legislation.gov.uk/ukpga/2013/33/pdfs/ukpga_20130033_en.pdf.

[30] Banking Reform Draft Secondary Legislation, available at https://www.gov.uk/government/consultations/banking-reform-draft-secondary-legislation.

[31] See Financial Services and Markets Act 2000 (Ring-Fenced Bodies and Core Activities) Order 2014 SI 2014/1960, available at http://www.legislation.gov.uk/uksi/2014/1960/pdfs/uksi_20141960_en.pdf.

[32] Ibid.

vital.[33] The ring-fencing policy aims to insulate banking services critical to individuals and SMEs from shocks elsewhere in the financial group or wider system by making it easier to ensure continuous provision of those services.[34] Indeed, the UK ring-fencing legislation has substantially influenced the European structural regulation debate and the proposed legislation on ring-fencing in France and Germany, especially with respect to guaranteeing genuine independence of the ring-fenced subsidiary.

The UK ring-fencing approach is important in two ways: (i) the structural separation is mandated prior to a crisis event. This assures that the separation is, indeed, enforceable and does not fail because the mere planning for such a separation turned out to be incomplete or to neglect the dynamics and time constraints of a crisis; and (ii) the legislative framework gives clear and compelling specifications on what assets and services are essential and how they will be shielded from contagion. This means that the regime leaves less room for interpretation by supervisors, banks and creditors,[35] as it becomes less flexible but more predictable.

The two most important elements of the UK ring-fence approach are: (i) the scope of the ring-fencing policy (or what the ICB labelled as the 'location'); and (ii) the legal, economic and operational independence of the ring-fenced bank (or what the ICB labelled as the 'height'). The details of the height and location are mostly defined in secondary legislation.[36] The purpose of defining the ring-fence in the legislative framework, rather than leaving it to be defined by regulators in their rulebook, allows the regulator to devote its resources to implementing the legislation and supervising compliance while avoiding constant negotiations and lobbying efforts by the banks to change the ring-fence in terms of its location and height.[37]

---

[33] See HM Treasury, Department for Business Innovation and Skills (BIS) (2012), at p 4. Compare ICB (2011), at p 14.

[34] A major objective of the UK ring-fencing regime is to maintain financial services vital to the economy during periods of banking sector stress. As discussed later, this is also an objective of the European Commission's proposed Regulation on structural regulation. See Liikanen Report (2012), at p 20.

[35] See Parliamentary Commission on Banking Standards (PCBS), 'Changing banking for good', 19 June 2013, at pp 57–61.

[36] See SI 2014/1960, *supra* n. 31.

[37] Lord King of Lothbury stated in evidence before the Parliament's Joint Select Committee on the Financial Services Act 2012: 'Our strong view is that as far as possible this should be done in legislation and not left to the regulator. I say that because the difficulty that will arise with this approach is that the banks and their lawyers will have enormous amounts of money, time and resources to come up with all kinds of clever ways to try to get round the rules set out in legislation. Unless those rules are pretty clear the regulator will be chasing the banks round in a circle and will come under enormous pressure… It should be for Parliament to define the ring-fence for retail banking. The definition may need adjusting from time to time and therefore should not be enshrined in primary legislation. Instead it should be set out in secondary legislation so it can be more easily reviewed and adjusted. It should not be left to the bank or the regulators to define the ring-fence'. See Joint Committee on the Draft Financial Services Bill, Draft Financial Services Bill (Session 2010–2012), 2011, at pp 186–187. See also Lord King's evidence to the Parliamentary Commission on Banking Standards, raising a similar concern: 'But if judgment ends up simply as a negotiation between the regulator and the regulated bank, there is only one winner in that, and that will be a very bad outcome. Clarity is crucial to enable the regulator to exercise judgment within a very well defined framework, and the regulator needs to be able to tell banks, "This is the capital requirement you will have", as opposed to merely entering into a negotiation', PCBS, *supra* n. 35, at p 38.

4 The Location of the Ring-Fence

4.1 Core Activities/Core Services

The ring-fence is designed to be erected around activities the temporary interruption of which could have severe implications for the UK economy. The ICB referred to these activities as 'mandated services', while the Banking Reform Act 2013 refers to them as 'core activities'.[38] Only a ring-fenced bank may engage in such 'core activities', which are accepting deposits and providing payment, withdrawal and overdraft facilities.

The acceptance of deposits is defined as a core activity under Section 142B of the Banking Reform Act that includes a UK credit institution taking deposits from individuals and small and medium-sized enterprises (SMEs),[39] both in the UK and abroad. Section 142C provides a list of related deposit services that are also considered 'core activities', including the provision of: facilities for accepting deposits or other payments into an account which is provided in the course of carrying on the core activity of accepting deposits; facilities for withdrawing money or making payments from such an account; and overdraft facilities in connection with such an account.

Besides accepting deposits, the Treasury acknowledges that other banking services might be of systemic importance. In particular, the provision of domestic credit to households and SMEs and payment and transaction services are included in the list of core activities.[40]

Under the Act, the Treasury can propose secondary legislation providing criteria which, if met by the deposit-taking institution, would exempt it from the ring-fencing requirement. Thus far, Parliament has approved secondary legislation adopting certain exemption criteria,[41] including a £25 billion *de minimis* rule, exempting banking institutions that take deposits amounting to less than £25 billion from the ring-fencing requirement. Other exemption criteria include allowing deposits from larger companies and certain high-net-worth individuals (HNWIs) to be placed outside the ring-fence upon explicit customer request, and building societies will not be considered ring-fenced banks.[42] UK branches of foreign (non-EEA) institutions may only accept deposits up to the *de minimis* threshold. However, if deposits exceed this threshold, the non-EEA headquartered parent will be required to incorporate a subsidiary and to comply fully with the ring-fencing requirements in order to accept further deposits in the UK.[43]

[38] SI 2014/1960, *supra* n. 31.

[39] Ibid. The Treasury uses a quantitative limit to define SMEs.

[40] Ibid.

[41] Ibid.

[42] However, the Building Societies Act of 1986 was amended to enhance institutional safeguards.

[43] SI 2014/1960, *supra* n. 31.

4.2 Excluded Activities

The legislation also provides that certain 'excluded activities' will be designated that are not allowed to take place in the same entity as the core activities.[44] In this regard, Section 142D provides that 'dealing in investments as principal', whether carried on in the UK or elsewhere, is an excluded activity.[45] This will affect vast areas of both investment and wholesale banking activities in the UK banking sector. Moreover, the Treasury has broad power to propose secondary legislation excluding other activities as well. For instance, Parliament approved, in 2014, secondary legislation that makes trading in physical commodities an excluded activity and prohibits ring-fenced bodies from having exposures to financial institutions other than in specified circumstances (for example, provision of trade finance to non-financial customers).[46]

The Treasury, however, can adopt exemptions from excluded activities in secondary legislation, allowing ring-fenced banks to undertake certain excluded activities or to create additional excluded activities. In this context, secondary legislation passed in July 2014 creates specific exemptions to allow a ring-fenced bank to manage its own risks (for example, interest rate risk on its lending portfolio) and to sell a limited range of simple risk management products (for example, simple interest rate swaps, currency forwards) to customers, subject to limits on the size and riskiness of the ring-fenced entity's derivative portfolio.[47] Selling derivatives to clients as principals has become one of the most controversial areas in the secondary legislation, as it goes against the ICB recommendations and might make the resolution of the ring-fenced entity more difficult. The same statutory instrument also provides that dealing in commodities is an excluded activity[48] based on the

[44] See The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 SI 2014/2080 (FSMA 2000). The ICB designation was 'prohibited activities'.

[45] The term 'dealing in investments as principal' is already defined in Article 14 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 as '[b]uying, selling, subscribing for or underwriting securities or contractually based investments (other than investments of the kind specified by article 87, or article 89 so far as relevant to that article) as principal is a specified kind of activity'. See FSMA (2000), Schedule 2, which contains a definition of 'dealing in investments' that includes both agents and principals.

[46] SI 2014/2080, *supra* n. 44.

[47] Ibid. Ring-fenced banks are prohibited from dealing in investments as principal and commodities trading, subject to the following exemptions: (1) managing the risks associated with its business including: changes in interest rates, exchange rates, or commodity prices; changes in any index of retail prices or of residential or commercial property prices; changes in any index of the price of shares; default risk; or liquidity risk; (2) buying, selling, or subscribing for investments which are liquid assets for the purpose of managing its liquidity; (3) selling derivatives to account holders that are traded by the bank on trading venues subject to certain restrictions (a departure from the ICB recommendations, which did not include permitting ring-fenced banks to sell derivatives to clients). These restrictions relate to the complexity of the derivatives, the types of risks to which the ring-fenced bank can expose itself when selling derivatives, and two caps on the activity: a 'net' cap and a 'gross' cap; (4) trading in liquid assets for the purpose of managing liquidity risk; (5) acquiring investments in exchange for a loan write-off; (6) acquiring debentures issued by itself, one of its subsidiaries or its parent undertaking.

[48] Ibid.

rationale that ring-fenced banks would be insulated against swings in global commodity prices.

4.3 Prohibitions

In addition, the Act authorises the Treasury to propose, and for Parliament to approve, secondary legislation that imposes prohibitions on ring-fenced banks. Such prohibitions work in a similar way to the excluded activities orders, but the prohibition orders are intended to capture transactions with specified types of counterparties or transactions in particular jurisdictions.[49] In other words, exclusions target activities, whereas prohibitions target people and places.

The prohibitions contain, among other things, exposure limits vis-à-vis third parties in order to prevent external contagion. The Treasury's secondary legislation for prohibitions is far-reaching, as it restricts 'any economic exposure' (with exceptions applying to payment arrangements, liquidity and risk management) to institutions that (i) engage in financial intermediation, and (ii) may be highly leveraged, have a high degree of maturity or liquidity mismatch, or have a high degree of financial interconnectedness. Explicitly mentioned as institutions that comply with those criteria are non-ring-fenced banks, investment firms, funds and insurance companies.[50]

Generally, the ring-fenced bank is not permitted to have exposures to 'financial institutions', aside from where such exposures relate to certain exempted activities that include: (1) entering into transactions for risk management purposes, intragroup transactions, and payments exposures; (2) facilitating trade finance; (3) issuing securitisation and covered bonds; (4) conducting conduit lending; (5) conducting repurchase agreement transactions; and (6) performing ancillary activities.

In addition, the prohibitions' regime restricts UK regulated banks from establishing branches or subsidiaries outside the European Economic Area (EEA). The UK bank entity must ensure that cross-border activities do not present a barrier to the resolution of ring-fenced assets (for example, by creating multiple jurisdictions or coordination difficulties with multiple resolution authorities). The ring-fenced bank shall not carry out any core activities through non-EEA branches. Instead, non-EEA operations will have to be undertaken in separate subsidiaries of the group.[51] Thus, the regime adopts some features of a geographical subsidiarisation requirement. In addition, the Treasury and the Prudential Regulation Authority require that all major service and credit contracts be written under the laws of an EEA Member State.[52]

The geographical limitation also mitigates the problem of a potential unequal treatment of foreign creditors, such as bondholders and depositors, and facilitates cross-border resolution. The limitation is based on the UK policy of not protecting

[49] Ibid.

[50] Ibid.

[51] See discussion in PCBS, *supra* n. 35, at pp 88–89.

[52] See HM Treasury/BIS (2012), para 2.24.

deposits in the non-EEA operations of UK banks, and of not providing essential services to their non-EEA operations. The geographic limitation on the ring-fenced bank's operations, however, is transparent and will have only a limited effect on the bank's operations because most of the bank's depositors and assets are booked in EEA jurisdictions. Indeed, Randell[53] suggests that the geographic limitation of the ring-fenced bank's operations provides resolution synergies that outweigh the unfairness to potential non-EEA creditors. In the case of resolution he observes that '[i]n addition, if a decision is taken to transfer only part of the business of this subsidiary or subsidiaries to a private sector purchaser or bridge bank, the exercise should also be considerably simpler than' under the pre-2013 law because the asset side of the subsidiary's balance sheet will consist predominantly of UK/EEA assets.[54] The EU Winding-up Directive should then ensure that the reorganisation measures undertaken by the UK authorities will be recognised in those jurisdictions (EEA states) where the assets are located. Moreover, geographical limitations may mitigate similar concerns with regard to depositor preference.[55] As the Treasury noted, limiting depositor preference should not have a significant impact 'in creating a perception that overseas creditors will be disadvantaged, as a substantial majority of insured deposits are expected to be in ring-fenced banks, which will not be able to branch outside of the EEA—only non-ring-fenced banks can do this'.[56]

4.3.1 The Height of the Ring-Fence

The Banking Reform Act requires the regulator to make rules to ensure that the ring-fenced bank is able to act independently of the rest of its group while providing services. The Act further specifies the areas where rules should be made, including holding shares in other corporate entities, entering into contracts with other members of the group, governance of the ring-fenced bank, restricting payments that a ring-fenced bank may make to other members of the group, and disclosure. These requirements are designed to ensure that a ring-fenced bank interacts with the rest of its group on a third-party basis and that it remains legally, economically and operationally independent.

The relationship between a ring-fenced body and the rest of its corporate group will be governed by rules made by the regulators (Prudential Regulation Authority (PRA)) and Financial Conduct Authority (FCA)). The Banking Reform Act requires the regulators to make rules, where reasonably practicable, to ensure that ring-fenced bodies are independent of other group members, and specifies particular areas where rules must be made (e.g., intra-group financial dealings). The precise content of the rules will be determined by the regulators.

[53] Randell (2011), at p 17.

[54] Ibid.

[55] See HM Treasury/BIS (2012), para 3.64.

[56] Ibid.

4.3.1.1 Legal and Operational Links[57] The ring fence shall provide for legal separability in times of financial distress and operational independence at all times. If the ring-fenced activity is carried out in a larger group, the ring-fenced bank must be established as a separate legal entity and is not allowed to hold shares of non-ring-fenced entities. In principle, banking groups remain free to organise their operational structures as they choose. If the regulator, however, finds that a group's management information systems, information technology and employment structures, among other things, present a barrier to the separation of a ring-fenced bank and the continuous provision of its services, the regulator shall require the group to make appropriate changes to its operations. Moreover, ring-fenced banks should not be permitted to use non-ring-fenced banks to access business-critical UK payment systems and networks.

The operational independence of the ring-fenced bank is defined according to the following principles: independent capitalisation and funding for any operational subsidiaries; an effective service level agreement between group entities; the provision of services by operational subsidiaries on an arm's length basis; and operational assets used for critical economic functions should be owned by the operational entity providing those services.

4.3.1.2 Economic Links[58] The restrictions on economic links between the ring-fenced bank and other group entities are not as 'high' or as strict as the requirements for legal and operational independence between the ring-fenced bank and group entities. Indeed, restrictions on economic links have been referred to as semi-permeable to a large extent. In principle, this means there should be few restrictions on the ability of the holding company or other affiliates in the group structure to downstream capital to the ring-fenced bank so as to support it in times of difficulty. On the other hand, safeguards should exist restricting the ability of the ring-fenced bank to upstream or transfer capital or other financial support to the holding company or other group affiliates respectively.[59]

These restrictions on economic links mean that ring-fenced banks will have to comply with capital and liquidity requirements on a stand-alone basis. Obviously, limiting economic links necessarily includes regulating internal group exposures as well. The Treasury agreed with the ICB that internal exposures should be treated as if those exposures were between third parties on an arm's length basis. The Capital Requirements Directive (CRD) IV[60] governs large exposures within banking groups and sets a cap of 25 per cent of the institution's tier-one capital in respect of exposures to other entities in the group.[61] Secondary legislation is likely to govern certain types of intra-group exposures more explicitly (for example, cross-default clauses, intra-group

[57] Ibid., paras 2.56–2.60.

[58] Ibid., paras 2.61–2.69.

[59] Ibid., paras 2.60–2.61. Because of reputational linkages as well as the fact that the structural separateness should enhance resolvability on both sides of the ring-fence, the Treasury is considering whether to impose certain (higher) limits on downstream financing, etc.

[60] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013, OJ 2013 L 176/338 (Capital Requirements Directive IV—CRD IV).

[61] Ibid., Arts. 129–133.

guarantees, and netting arrangements) as well as to establish rules on how to ensure that intra-group transactions are disclosed and undertaken under market conditions.

4.3.1.3 Governance and Disclosure[62] The independence of a ring-fenced bank must be underpinned by strong governance. The key to independent governance will be: (i) the composition of the board; and (ii) a requirement on board members to act in the interests of the ring-fenced bank (as opposed to the group as a whole) and to protect the ring-fence.

The Treasury has submitted secondary legislation recommending that at least half of the board as well as the chair of the ring-fenced bank (RFB) are independent and that no more than one-third of the RFB board are representatives of the rest of the group. In essence, the latter requirement permits the board members from the rest of the group to have the opportunity to influence a group-wide strategy, whilst the former requirement allows the majority of the RFB board to veto any strategy that might undermine the RFB's future prospects and stability. In addition, ring-fenced banks should have their own board committees—providing that independence in selecting the board, in setting a risk appetite for the firm and in setting its pay structures is primarily a matter for the ring-fenced bank.[63] In order to strengthen the market signal (as well as to mitigate reputational damage), the ring-fenced bank should be able to demonstrate publicly that it is independent. The precise content and scope of these disclosures are controversial and will be clarified in secondary legislation.

Finally, UK ring-fencing differs from measures to prohibit proprietary trading (such as the Volcker Rule in the USA or the ban on proprietary trading included in the draft European Commission regulation on structural reform of EU banks) in that it does not distinguish between proprietary trading and other economically similar forms of trading such as market-making. All dealing in investments as principal, i.e., on the bank's own balance sheet, is excluded from the UK ring-fence (except where covered by one of the exemptions described earlier), but can be conducted by other entities or subsidiaries within the group.

5 The EU Commission's Proposal in Light of Other Structural Reforms

The European Commission's 2014 proposed Regulation[64] on structural reform, which is based on the proposals of the High-Level Expert Group chaired by Erkki Liikanen, follows various reforms enacted in the United States, the United

[62] See, generally, HM Treasury/BIS (2012), paras 2.70–2.74.

[63] The ICB also suggested that the boards of the ring-fenced bank and of its parent company should have a duty to maintain the integrity of the ring fence and to ensure that the ring-fence principles are followed at all times. See discussion in ICB (2011), at p 72. The Parliamentary Commission on Banking Standards strengthened this view by criticising the language in the draft Banking Bill as vague. See PCBS, *supra* n. 35, at pp 6 and 91–94.

[64] Commission Proposal of 29 January 2014 for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, COM(2014) 43 final (Commission Proposal). The Commission's proposed Regulation aims to safeguard core financial activities, such as lending to the economy, by separating them from risky trading activities. This would also curb the current cross-subsidisation of trading activities by deposits, thus increasing the incentives for banks to lend to the real economy.

Kingdom, France and Germany. The draft Regulation[65] is the latest legislative measure on structural regulation to address the risks and intra-group exposures associated with certain trading activities and to enhance resolvability.[66] It requires the separation of deposit-taking from trading and bans proprietary trading. The UK Treasury believes that the Commission's proposal is broadly compatible with the UK ring-fencing approach and should enable the implementation of existing UK legislation on ring-fencing, which in some respects goes beyond the proposed Regulation.[67]

The Commission's draft Regulation, inspired by the US Volcker Rule and the 2012 Liikanen Report,[68] combines two general approaches inherent to the other reforms, namely: a) banning specific trading activities defined as proprietary; and b) requiring certain trading activities to be carried out by separated entities. These approaches are outlined below.

5.1 General Ban on Certain Trading Activities

The US has implemented a general ban on proprietary trading through Dodd-Frank's Volcker Rule, affecting any insured US depository institution as well as their controlling companies or affiliates.[69] The US federal regulators defined the scope of the Volcker Rule and subjected it to extensive conditions.[70] For example, the Securities Exchange Commission provided a list of exempted activities in its

[65] The draft Regulation has now been transmitted to the European Parliament (EP) and Council. The EP appointed a rapporteur for the file in July 2014. The first Council working group meeting took place on Thursday 18 May 2014 and key items on the agenda included scope of application and the proprietary trading ban. The bulk of the negotiations, however, took place in the second half of 2014 and in 2015.

[66] In MEMO/14/63 of 29 January 2014, the Commission stated: 'The separation of trading activities from a deposit-taking entity within a banking group would considerably facilitate bank resolution. Better structured groups make it easier to isolate the problem than when the group structure is opaque'.

[67] See Bank of England Memo, 19 April 2014 (on file with author). It therefore is assumed that structural reforms in the UK will be implemented in accordance with the existing UK legislation.

[68] Liikanen Report (2012).

[69] 12 US Code §1851(a)(1)(A), §1851(h)(1). Another type of US structural regulation involves enhanced prudential standards for Foreign Banking Organisations (FBO) in which an FBO with US non-branch assets of at least $50 billion will be required to hold its US subsidiaries through a US intermediate holding company, which is subject to US capital, liquidity, capital governance and planning and stress testing similar to the requirements of a US bank holding company. See Federal Reserve System, 12 C.F.R. Part 252, Regulation YY, Enhanced Prudential Standards for Bank Holding Companies and Foreign Bank Organizations.

[70] Section 619 of the Dodd-Frank Act contains the Volcker Rule, which prohibits banks from proprietary trading and entering into certain relationships with hedge funds and private equity funds. Differentiating proprietary trading from permissible hedging will involve complex determinations. Moreover, the Dodd-Frank Act contains a 'swaps push-out rule' that limits the types of swap activity that financial institutions which are registered as swap dealers or major swap partners or security-based dealers or security-based swap partners that receive federal assistance (i.e., deposit insurance and Federal Reserve discount window access) can engage in. See Section 716 of the Dodd-Frank Act, Title VII. As discussed below, these structural regulations may have the unintended consequence of decreasing the efficiency of firms, and moreover, by applying the prohibition on proprietary trading only to banks, of increasing risks by incentivising banks to move proprietary trading to less regulated areas.

Final Rule, including risk-mitigating hedging activities,[71] underwriting activities[72] and market making-related activities.[73]

The Commission's draft Regulation, in contrast, imposes a ban both on proprietary trading in a somewhat narrower sense[74] and on specific investment transactions that do not qualify as proprietary trading per se.[75] To assist enforcement, such proscribed and restricted activities may not be encouraged or rewarded by the entity's remuneration policies.[76] However, due to its narrow wording, the draft Regulation's ban on proprietary trading does not include underwriting activities, market making-related activities, or transactions to hedge risks resulting from client activity.[77] The draft Regulation further exempts specific trading of commodities and certain sovereign bonds from the ban.[78]

The proposed ban on proprietary trading would apply to EU banks, EU parents, their branches and subsidiaries, as well as EU branches of non-EU banks, provided any of these institutions either have been identified as a global systemically important bank (G-SIBs) under Article 131 of the CRD IV,[79] or have assets and trading activities exceeding certain limits.[80] An estimated 30 bank groups will fall under the draft Regulation's coverage.[81] This is a larger number of bank groups than that captured under the UK ring-fence rules. The draft Regulation applies to EU-based G-SIBs and/or those firms which meet thresholds for a balance sheet size of €30 billion and trading assets exceeding either €70 billion or ten per cent of total assets for three consecutive years. It also has a broad territorial scope, capturing banks' overseas operations and EU-based branches/subsidiaries of non-EU banks (although exemptions may apply). Significantly, insofar as they are subject to a legal framework deemed 'equivalent' by the EU Commission under Article 27(1), both EU branches of foreign banks and foreign subsidiaries of EU parents will fall outside the scope of the Regulation,[82] including with regard to the separation requirements discussed below.

[71] 12 US Code §1851(d). The four US federal regulators have adopted proposed rules to define conditions of and exemptions from the Volcker rule. See SEC Final Rule, § 17 CFR Part 255.

[72] SEC Final Rule, § 17 CFR Part 255.

[73] Ibid., § 17 CFR Part 255.

[74] Commission Proposal, Art. 6(1)(a); Art. 5(4) defines proprietary trading as 'using own capital or borrowed money to take positions in any type of transaction to purchase, sell or otherwise acquire or dispose of any financial instrument or commodities for the sole purpose of making a profit for own account, and without any connection to actual or anticipated client activity or for the purpose of hedging the entity's risk as result of actual or anticipated client activity, through the use of desks, units, divisions or individual traders specifically dedicated to such position taking and profit making'.

[75] Ibid., Art. 6(1)(b).

[76] Ibid., Art. 7.

[77] The latter being explicitly exempted in the Commission Proposal, *supra* n. 74, Art. 5(4).

[78] Ibid., Arts. 6(2)(a) and 6(6).

[79] Ibid., Art. 3(1)(a).

[80] Ibid., Art. 3(1)(b), namely when having total assets of at least €30 billion and trading activities exceeding either €70 billion or 10 % of total assets for 3 consecutive years.

[81] MEMO/14/63, *supra* n. 66.

[82] Commission Proposal, *supra* n. 74, Art. 4(1)(a)–(b).

5.2 Trading Activities Triggering Separation

Prior to the Commission proposal, some EU states had already adopted structural reform legislation to address the risks associated with proprietary trading and intra-group exposures that requires some degree of separation between the insured deposit-taking and trading entities or subsidiaries within the financial group structure. It is intended that such structural separation or subsidiarisation within the group will facilitate a resolution of the group if its solvency is threatened, and allow public authorities to confine taxpayer support to the retail deposit-taking subsidiary and the interbank payment system. Two sub-approaches can be distinguished based on the separated entity.

5.2.1 Subsidiarisation and Ring-Fencing Requirements in National Legislation

In contrast to the Commission's draft Regulation, the subsidiarisation approach proposed by the Liikanen Report consists in allowing proprietary trading only insofar as it is carried out by a legally, economically and operationally separate trading subsidiary, which is then prevented from deposit-taking activities. The structural reform legislation enacted in Germany[83] and France[84] follows this model.

The German reform legislation applies to 'credit institutions', as defined under Article 4(1)(1) of the Capital Requirements Regulation (CRR),[85] which may only carry out certain trading activities through a legally, economically and operationally separate 'financial trading institution' (*Finanzhandelsinstitut*).[86] The subsidiarisation requirement applies either when trading activities by the entity or the group exceed certain thresholds,[87] or when the German regulator deems the trading activities too risky for the credit institution's solvency.[88] In the former case, the requirement applies to transactions for own account, which may only be carried out by the trading subsidiary,[89] while market-making activities[90] and transactions to hedge client activity[91] are exempted from subsidiarisation; in the latter case, the requirement imposed by the German regulator not only applies to transactions for own account, but may extend to any financial transaction deemed to entail comparable risks.[92]

[83] *Gesetz über das Kreditwesen* (KWG—Banking Act), §3 and 25f, as amended by the *Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen vom 7 August 2013*.

[84] *Code monétaire et financier*, Art. L511-47ff as amended by *Loi no 2013–2672 du 26 juillet 2013 de Séparation et de Régulation des Activités Bancaires*.

[85] §1(3d) KWG.

[86] §25f(1) KWG.

[87] §3(2)(1)(1) and 3(2)(1)(2) KWG, namely when trading assets exceed €100 billion for the past financial year, or when such assets exceed 20 % of total assets for the past three financial years (at least €90 billion).

[88] §3(4) KWG.

[89] §3(2)(2) KWG.

[90] §3(2)(2)(3) KWG.

[91] §3(2)(3)(1) KWG.

[92] §3(4)(1)(2) KWG. Regardless of whether they entail comparable risks, the regulator may also prohibit market-making activities (§3(4)(1)(1) KWG).

The French reform similarly subjects credit institutions, financial companies and mixed financial holding companies to a subsidiarisation requirement should their trading activities exceed certain limits,[93] which has been defined in statute as 7.5 % of the group's total balance sheet.[94] The French regime defines proprietary trading as financial transactions 'involving' own account,[95] but explicitly exempts underwriting,[96] hedging,[97] and market-making activities[98] for which no subsidiarisation is required. Once subsidiarised, the trading entities are prohibited from providing deposit-taking services.[99]

As discussed above, the UK's ring-fencing approach, in contrast, consists in making the deposit-taking entity a legally, economically and operationally independent entity from the rest of its group,[100] ensuring that it remains unaffected by the activities of other members, especially by their insolvency.[101] The ring-fenced banks are then prohibited from carrying out proprietary trading activities ('dealing in investments as principal').[102]

5.2.2 Separation Requirements in the EU Proposal

In the draft Regulation, the Commission went beyond the Liikanen Report's proposals by linking separation requirements not to proprietary trading (which is subject to an outright ban) but to trading activities in general. The Regulation defines trading activities in a negative way by specifying what they are not: any activity that does not consist in deposit-taking, lending, or other enumerated services.[103]

The competent supervisory authority (i.e., the national competent authority or, in most EU states in the Banking Union, the European Central Bank) will regularly review specific metrics linked to the trading activities of (1) EU banks taking EU-eligible deposits, so-called 'core credit institutions'; (2) EU parents having deposit-taking banks in their group; and (3) EU branches of non-EU banks.[104] If the metrics exceed certain limits, the authority will need to initiate separation.[105] Should the

93 *Code monétaire et financier*, Art. L511-47(I).

94 See Council of State Decree 2014–2785 of 8 July 2014, adopting the 7.5 % threshold that is required in Article L511-47 of the French Monetary and Financial Code, defining the threshold as based on the value of financial assets of the total group balance sheet.

95 Ibid., Art. L511-47(I)(1).

96 Ibid., Art. L511-47(I)(1)(a).

97 Ibid., Art. L511-47(I)(1)(c) and (IV).

98 Ibid., Art. L511-47(I)(1)(d) and (V).

99 Ibid., Art. L511-48(I).

100 HM Treasury, Sound banking: delivering reform, Cm 8453, October 2012, para 2.36.

101 See FSMA 2000, s 142H(4) as amended by the Financial Services (Banking Reform) Act 2013.

102 Ibid., s 142D(2) as amended by the Financial Services (Banking Reform) Act 2013.

103 Commission Proposal, *supra* n. 74, Art. 8.

104 Ibid., Art. 9.

105 Ibid., Art. 10(1); the relevant limits will be specified in delegated acts by the Commission (Art. 10(4)).

metrics remain under the relevant limits, the authority will have the discretion to decide whether to initiate separation.[106]

Once the separation has been triggered, the trading activities may only be carried out by a group entity that is legally, economically and operationally separate from the deposit-taking bank.[107] Such trading entity will be prohibited from taking deposit guarantee-eligible deposits or providing retail payment services, except when necessary for the exchange of collateral related to trading activities.[108] Conversely, the deposit-taking bank may then only carry out trading activities for the purpose of prudently managing its capital, liquidity and funding[109] and may continue selling derivative instruments only under certain conditions.[110]

The draft Regulation, however, allows the Commission to approve certain structural reforms previously adopted by Member States. Should national legislation adopted before 29 January 2014 be deemed equivalent by the Commission, Member States may obtain a derogation from the draft Regulation's separation requirements for certain deposit-taking banks.[111] The structural reforms adopted by France, Germany and the UK are likely to qualify.

In summary, the Commission Proposal is not calling for a break-up of European universal banking groups. Universal banks would continue to serve clients with a broad set of services and financial products. The reform measures proposed would instead simplify the way the too-big-to-fail (TBTF) banks operate and would facilitate their resolvability. This is partly why, under Article 4(2) of the proposal, the draft Regulation allows the national competent authority to exempt non-EU subsidiaries of EU banks from the ring-fencing requirements of the proposal (even if the host country does not provide any equivalent ring-fencing rules) as long as a sufficiently robust group-level resolution strategy between the host country and the Union is in place.

Regarding the French and German laws, both structural reforms were part of a broader legislative package that included implementation of bank recovery and resolution regimes (*Mise en place du régime de résolution bancaire* and *Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen* respectively). Improved resolution was therefore an important objective of both legislative packages; however, resolvability was not expressly mentioned in either country's legislation on structural reform.

That said, it seems that any separation of risky activity is arguably a step towards enhanced resolvability, including the separation rules under both the French and the German regime. Nevertheless, this view is questioned by the Belgian National Bank in its 2013 Report[112] on structural reform, which assesses whether the different regimes actually 'improve resolvability'. It states that, in France and Germany, the amount of

[106] Ibid., Art. 10(2).

[107] Ibid., Art. 13.

[108] Ibid., Art. 20.

[109] Ibid., Art. 11.

[110] Ibid., Art. 12.

[111] Ibid., Art. 21. Belgium's structural banking legislation was adopted in 2014 and is similar to France's and Germany's legislation, but will not be addressed in this article.

[112] See National Bank of Belgium (2013), at p 2.

trading book activity left in the banking group fails to significantly improve resolvability—perhaps because the threshold of assets and activity triggering subsidiarisation is too high, or because the definition of proprietary trading requiring subsidiarisation is too narrow. Nevertheless, generally, the European Union approach—both the Commission's proposal and the UK, French and German ring-fencing regimes—views resolvability as an important objective of ring-fencing.

6 The Pros and Cons of Ring-Fencing

The debate over the advantages and disadvantages of structural reforms consists of a wide range of opinions.[113] For the industry and others the reforms are obviously too strict and disproportionate, whilst others view the reforms as inadequate and not going far enough in creating a Glass-Steagall-like or narrow banking separation. And yet others believe that regulating the institutional structure will simply lead to other forms of evasion and arbitrage that will allow risks to shift to other parts of the financial system outside of the financial group structure, thereby creating other types of systemic risks presently unperceived by regulators.[114]

6.1 Advantages

Ring-fencing can enhance resolvability and limit the potential government guarantee. Most commentators agree that there are four main advantages to regulating structure.[115] Firstly, the structure enhances separability, and so the resolvability, of financial institutions. It is simpler to transfer the ownership of an existing legal entity than it is to identify from within a large integrated balance sheet all of the retail assets and liabilities and to transfer them. When activities are completely integrated there is also no assurance that individual activities, or groups of activities, will be viable on their own. The key benefit of separation is, thus, that it makes it easier for the authorities to require creditors of failing retail banks, failing wholesale/investment banks, or both, to bear losses, instead of the taxpayer. The evident transparency of the entire regime to all creditors will substantially reduce any expectation by market participants that they will be bailed out and, thus, reduce perceived government guarantees. More generally, ring-fencing may also improve market discipline because of a greater degree of transparency around the financial resources available to each business line.

Secondly, different activities may enjoy different levels of perceived government guarantee. Retail deposit-taking, at one extreme, is partially backed by explicit insurance while proprietary trading of financial instruments is not justified in receiving a government guarantee or other taxpayer support. Combining financial activities in a single entity makes it harder for the authorities to treat each activity differently in resolution while extending the scope of the perceived government guarantees to activities that would ordinarily not merit protection. Importantly, separation also allows the authorities to distinguish between creditors of the retail

113 Ibid.

114 Thiessen (2012), at pp 169–70.

115 See ICB (2011), paras 4.60 and 4.78–4.80.

bank and creditors of other entities in the banking group in a way that they cannot do if activities are conducted in the same legal entity.

Thirdly, structural change could help to address a time inconsistency problem in addressing the too-big-to-fail (TBTF) problem—authorities in the heat of a crisis will always face enormous pressure to support banks despite the negative consequences this has for moral hazard. Separating retail banks, where the political pressure will always be greatest, from other activities should help to alter the incentives of the authorities so that they are less likely to support these other activities.

Fourthly, ring-fencing reduces complexity as well as the single entity's size, which again enhances supervision, resolvability and market discipline by providing more than an 'all or nothing' option for the authorities.[116] Indeed, Sir John Vickers, former chairman of the British Independent Commission on Banking, observed that a ring-fence could help reduce the systemic risks associated with complexity and size, but not necessarily because retail banking is less risky than wholesale or investment banking. Rather, ring-fencing allows the authorities to maintain the continuous provision of retail services through resolution of a smaller and simpler entity. Similarly, Erkki Liikanen argued that '[s]eparation of these activities into separate legal entities is the most direct way of tackling banks' complexity and interconnectedness'. And as separation would make banking groups 'simpler and more transparent, it would also facilitate market discipline and supervision and, ultimately, recovery and resolution'.[117]

6.2 Disadvantages

On the other hand, ring-fencing can result in arbitrage and shifting of much of the riskiest bank behaviour off balance sheet and away from supervisory scrutiny. This could create the opportunity for many under-regulated non-bank financial firms (for example, asset management firms) to take on much of the trading that European banks are beginning to shift off their balance sheet to comply with CRD IV and structural reforms.[118] Moreover, the fundamental assumption of the ring-fencing policy is that investment banking activities are riskier as well as less beneficial to social welfare (and, thus, also less worthy of protection) than more traditional retail banking activities. Not surprisingly, many arguments in favour of ring-fencing are an indirect form of critique regarding pre-crisis behaviour and the disproportionate role that certain high-risk investment banking activities had come to play in the economy.[119] This critique, however, fails to take account of the important synergies and economies of scale and scope that the provision of universal banking services, including so-called risky trading activities, provides for the economy in the form of lower-cost provision of retail financial services and risk mitigation for the bank itself in offering a broader range of products and services.

[116] Ibid., para 4.63.

[117] Liikanen Report (2012), at p 100.

[118] See PWC (2014), at pp 7–8.

[119] See M Wolfe, 'Why finance is too much of a good thing', Financial Times, 26 May 2015, and J Kay, 'The war on moral hazard begins at home', Financial Times, 25 January 2011.

In addition, ring fencing or structural regulation of the banking sector does not adequately address the financial stability risks associated with small and medium-sized banks which are not involved in investment banking or risky trading activities but which make too many risky loans. Indeed, the experience of the US savings and loan crisis of the 1980s and later the collapse of the British banks Northern Rock, Bradford and Bingley, and Alliance and Leicester in 2007–2008 respectively suggest that banking crises can arise from poor underwriting and weak regulation in traditional bank lending and not necessarily from risky securities and derivatives trading.

7 Does the EU Resolution Regime Make Ring-Fencing Unnecessary?

The UK Banking Act 2013 and the Commission's draft Regulation emphasise the importance of the ring-fencing requirement as a tool to enhance the resolvability of large complex banking organisations. Ring-fencing is potentially beneficial to bank resolution in two ways. Firstly, it may make post-bail-in restructuring easier to execute because of the transparency of the group's ring-fenced structure that allows bail-in to be imposed on the group's investment banking liabilities before being applied to the liabilities of the retail bank. Secondly, it may provide for fallback options for the resolution authority where losses are greater than the gone concern loss-absorbing capacity (GLAC) of the holding company (although any fallback measure is likely to be disruptive and disorderly).

Ring-fencing can facilitate post-bail-in restructuring by providing separability between core business lines and functions that are conducted by the ring-fenced bank (RFB) and those tasks and functions that are conducted by the non-ring-fenced bank (NRFB). The effectiveness of the separability will depend on ring-fencing delivering some or all of the following in respect of the degree of separation between the RFB and the NRFB: the RFB and NRFB do not depend on each other operationally (for example, they should depend on a separate group service company); they do not book risk onto each other's balance sheets; they each have distinct franchise value and client relationships; they each have stand-alone access to financial market infrastructures, including payment and settlement systems; and they have distinct and separate human resource and governance arrangements.

These considerations, however, are not unique to banks subject to ring-fencing. There are ways to deliver these outcomes without ring-fencing; and post-bail-in restructuring may require splitting business lines and functions within either the ring-fenced bank or the non-ring-fenced bank, in which case pre-bail-in ring-fencing may not be helpful.

Resolution authorities may also find ring-fencing beneficial because it provides fallback options where losses are greater than the GLAC of the banking group's holding company. For instance, if losses are greater than the GLAC at holding company level but confined to either the RFB or NRFB, ring-fencing may be beneficial in two ways: by insulating or, in certain circumstances, transferring to a bridge bank or a private sector purchaser (PSP), the non-loss generating part of the group; and/or in respect of bailing in operating liabilities of the loss-generating part of the group (whether the RFB or the NRFB), it should be relatively less disruptive to bail in operating liabilities of either the RFB or the NRFB than to bail in those operating liabilities had both the RFB and NRFB functions been conducted out of a single legal entity. Both of these options, however, are likely to be highly disruptive and disorderly. In addition, ring-fencing is unlikely to deliver stand-alone viability of either the RFB or NRFB (where the other part of the group is failing), although meeting the separability conditions listed above should help.

Where losses are spread more evenly across both the RFB and NRFB, ring-fencing may not deliver much in the way of fallback resolution options. But ring-fencing may reduce the likelihood that both the RFB and NRFB are simultaneously loss making (for example, because of reduced cross-booking of risk, distinct management or governance arrangements, and higher capital and leverage ratio requirements for the RFB).

On the other hand, the single point of entry (SPE) resolution process itself can achieve the key outcomes that ring-fencing was designed to achieve.[120] Notably, SPE ensures continuity of core retail functions, along with all other critical functions in a group (whether they are located in the RFB, NRFB or other parts of the group); and by reducing the TBTF subsidy for a bank as a whole, it achieves the same outcome as trying to reduce, through ring-fencing, the TBTF subsidy derived from the integration of the wholesale and investment banking businesses with the retail bank business (where the retail business is deemed TBTF). Furthermore, it is highly doubtful whether these outcomes could be achieved by ring-fencing alone, for example, without a credible group-wide resolution strategy.

In addition, ring-fencing may also have certain second-order benefits for resolution. For instance, the transfer of debt from the bank subsidiary to the holding company may become cheaper if the bank subsidiary is separated into ring-fenced and non-ring-fenced entities. Such separation may also simplify collateral arrangements, therefore making liquidity provision to the ring-fenced bank more manageable if the rest of the group or other entities in the group are in resolution.

Nevertheless, whatever benefits structural regulation has for prudential supervision or resolution, its efficacy in the European Union can be called into question because of the substantial powers allocated to bank resolution authorities under the Bank Recovery and Resolution Directive (BRRD).[121] Under the BRRD, resolution authorities can require banks or banking groups to change their organisational structure if the authority determines anytime that the bank or group's structure is a substantial impediment to a feasible and credible resolution of the bank or group.[122] Specifically, Article 17(5) empowers the resolution authority to conduct a resolvability assessment to identify whether or not there are substantial impediments to the implementation of a credible and feasible resolution plan. If the authority determines that there are substantial impediments to the implementation of the plan, it may order the institution to remove the impediments, including changing its organisational structure or business activities. Indeed, this could involve changes to

[120] See Federal Deposit Insurance Corporation and Bank of England (2012).

[121] Bank Recovery and Resolution Directive 2014/59/EU of 15 May 2014 OJ 2014 L 173/190 (BRRD).

[122] Ibid., Art. 17(5).

the legal, operational and financial structure of institutions or the group itself and their business activities.[123]

Articles 15 and 16 of the BRRD provide that the resolution authority must consult the competent supervisory authority when it determines whether or not there are substantial impediments to the resolvability of a firm.[124] The resolution authority is required to notify the firm in writing of any substantial impediments they have identified, and the firm or group will have the opportunity to address these concerns and propose measures to eliminate these impediments. Article 17(5) of the BRRD provides that if the firm's or group's proposals are considered inadequate, the resolution authority will have the power to take specific actions that address or remove the impediments to resolvability.[125] In selecting the appropriate measure to remove the impediments, resolution authorities have wide discretion to choose a measure based on the nature of the impediment. These measures can be classified into three categories—structural, financial and information or data management.

---

[123] Ibid., Art. 17 sets out procedural and substantive rules about how the institution or group can be required to reduce or remove identified organisational impediments.

[124] Ibid., Art. 15 applies this requirement to individual credit or investment institutions and Art. 16 applies it to banking groups subject to consolidated supervision.

[125] Ibid., Art. 17(5) provides a non-exhaustive range of powers for authorities to remove firm impediments to resolvability in advance of failure, which may be used if measures proposed by firms are insufficient to ensure resolvability:

(a) require the institution to revise any intragroup financing agreements or review the absence thereof, or draw up service agreements, whether intra-group or with third parties, to cover the provision of critical functions;

(b) require the institution to limit its maximum individual and aggregate exposures;

(c) impose specific or regular additional information requirements relevant for resolution purposes;

(d) require the institution to divest specific assets;

(e) require the institution to limit or cease specific existing or proposed activities;

(f) restrict or prevent the development of new or existing business lines or sale of new or existing products;

(g) require changes to legal or operational structures of the institution or any group entity, either directly or indirectly under its control, so as to reduce complexity in order to ensure that critical functions may be legally and operationally separated from other functions through the application of the resolution tools;

(h) require an institution or a parent undertaking to set up a parent financial holding company in a Member State or a Union parent financial holding company;

(i) require an institution or entity referred to in point (b), (c) or (d) of Art. 1(1) to issue eligible liabilities to meet the requirements of Art. 45;

(j) require an institution or entity referred to in point (b), (c) or (d) of Art. 1(1), to take other steps to meet the minimum requirement for own funds and eligible liabilities under Art. 45, including in particular to attempt to renegotiate any eligible liability, additional Tier 1 instrument or Tier 2 instrument it has issued, with a view to ensuring that any decision of the resolution authority to write down or convert that liability or instrument would be effected under the law of the jurisdiction governing that liability or instrument; and

(k) where an institution is the subsidiary of a mixed-activity holding company, requiring that the mixed-activity holding company set up a separate financial holding company to control the institution, if necessary in order to facilitate the resolution of the institution and to avoid the application of the resolution tools and powers referred to in Title IV having an adverse effect on the non-financial part of the group.

Under Article 17(9) of the BRRD, the European Banking Authority (EBA) is authorised to develop guidelines[126] specifying further details on the measures and the circumstances in which each measure may be applied in order to support a consistent application of such measures by Member States.[127] And Article 85 of the BRRD requires that there is a right of appeal against a decision to take a crisis prevention measure[128] which includes a requirement to remove impediments to resolvability.

Similarly, the Single Resolution Mechanism Regulation (SRMR) for the Member States participating in the Banking Union requires the Single Resolution Board (SRB) to draw up resolution plans after consultation with the national competent authorities (including the European Central Bank) and national resolution authorities, including the group resolution authority. Article 10(11) of the SRMR is equivalent to Article 17(5) of the BRRD in so far as the SRB, when drafting and revising the resolution plan, shall identify any material impediments to resolvability and, based on the EU legal principles of necessity and proportionality, propose relevant measures to the resolution authorities to address those impediments.[129] The SRB can require the relevant national resolution authority to take specific measures to order the institution to remove the impediments if the institution subject to resolution powers can potentially draw on funds from the Single Resolution Fund.[130]

Based on these provisions of the BRRD and SRMR, the *raison d'etre* of the Commission's structural regulation proposal can be called into question. If the primary purpose of the draft Regulation is to facilitate bank recovery and resolution

[126] The EBA has developed Guidelines on conditions for measures to overcome obstacles to resolvability for resolution authorities to rely on in considering whether to take measures under BRRD, Art. 17(5).

[127] BRRD, Art. 17(5) provides that the EBA should support a consistent application of such measures across the Union.

[128] See BRRD, Art. 2(1)(101) (defining what a measure is that can be challenged on appeal).

[129] Ibid., Art. 10(11) states: 'For the purpose of paragraph 10, the Board, where applicable, shall instruct the national resolution authorities to take any of the following measures: (a) to require the entity to revise any intragroup financing agreements or review the absence thereof, or draw up service agreements (whether intra-group or with third parties) to cover the provision of critical functions; (b) to require the entity to limit its maximum individual and aggregate exposures; (c) to impose specific or regular additional information requirements relevant for resolution purposes; (d) to require the entity to divest specific assets; (e) to require the entity to limit or cease specific existing or proposed activities; (f) to restrict or prevent the development of new or existing business lines or sale of new or existing products; (g) to require changes to legal or operational structures of the entity or any group entity, either directly or indirectly under their control, so as to reduce complexity in order to ensure that critical functions may be legally and operationally separated from other functions through the application of the resolution tools; (h) to require an entity to set up a parent financial holding company in a Member State or a Union parent financial holding company; (i) to require an entity to issue eligible liabilities to meet the requirements of Article 12; (j) to require an entity to take other steps to meet the requirements referred to in Article 12, including in particular to attempt to renegotiate any eligible liability, Additional Tier 1 instrument or Tier 2 instrument it has issued, with a view to ensuring that any decision of the Board to write down or convert that liability or instrument would be effected under the law of the jurisdiction governing that liability or instrument. Where applicable, the national resolution authorities shall directly take the measures referred to in points (a) to (j) of the first subparagraph'. OJ L 225/32, 30.7.2014.

[130] SRMR, Art. 10(11): 'Where applicable, the national resolution authorities shall directly take the measures referred to in points (a) to (j) of the first subparagraph'.

by proposing or permitting a particular set of pre-bail-in organisational structures for banking groups, then the utility of this proposal is substantially undermined by the broad powers granted to Member State resolution authorities to require banking groups to reorganise themselves or change their institutional structures in any way (subject to the EU legal principle of proportionality) that the resolution authority believes is necessary to promote a more effective resolution of the banking group during times of distress. This results potentially in a direct conflict between the legal requirements of a Member State's ring-fence law and the power of the Member State resolution authority to impose on a banking group reorganisation requirements to ensure its resolvability. In other words, a banking group, fully compliant with its jurisdiction's requirements for structural regulation, can be ordered by its resolution authority—at any time prior to a resolution or restructuring event—to change its organisational structure in order to enhance its resolvability. This creates significant legal uncertainty for the banking group and limits the effectiveness of the Member State's structural regulation law. These substantial powers for resolution authorities certainly raise questions about the need for any EU legislation permitting or disallowing certain pre-bail-in organisational structures for banks and banking groups.

8 Conclusion

This article analyses recent developments in the regulation of the institutional structure of banking groups in the European Union. Particular attention is paid to the British banking sector and how the global financial crisis of 2007-08 led to the United Kingdom adopting ring-fenced banking legislation and related structural regulatory reforms. The article then analyses the EU Commission's proposed legislation to regulate the organisational structure of European banks and banking groups. The Commission's proposed Regulation aims to limit risky securities and derivatives trading activities in large banking groups and to recognise as equivalent certain Member State laws that already require most risky trading to take place in separate subsidiaries independent from the group's retail banking operations. Although these legislative measures have the primary aim of improving bank resolvability and limiting excessive risk-taking, they will also have the unintended effect of reducing the economic benefits of risk diversification and limiting financial product offerings that universal banks have traditionally provided to their customers. Moreover, the various limitations and prohibitions on bank trading will probably not lead to a reduction of harmful risk-taking in the financial sector but to a shift of risk-taking away from the banking sector (where it can be monitored by supervisors) to under-regulated areas of the financial system. Also, structural regulation does not address the systemic banking risks that can arise from poor underwriting and weak regulation of relatively straightforward bank lending activities. All of this should call for caution in considering proposals for structural regulation of the EU banking sector that have as a primary focus the limitation of excessive bank risk-taking in securities and derivatives trading.

References

Bentson GJ (1994) Universal banking. J Econ Perspect 8(3):121
Brunnermeier M, Crockett A, Goodhart CAE, Persaud AD, Shin H (2009) Fundamental principles of financial regulation. 11 Geneva Reports on the World Economy, ICMB, Geneva
Canals J (1997) Universal banking. Oxford University Press, Oxford
Clapham J (1944) The Bank of England—a history, vol I. 1694–1797. Cambridge University Press, Cambridge
Committee on Global Financial System (2012) Principles for the supervision of financial conglomerates: final report. Available at http://www.bis.org/publ/joint29.pdf. Sep 2012
Crick WF, Wadsworth JE (1935) A hundred years of joint stock banking. Hodder & Stoughton, London
Darling A (2011) Back from the brink: 1000 days at number 11. Atlantic Books, London
Eiteman DK, Stonehill AI, Moffett MH (2004) Multinational business finance, 10th edn. Pearson, London
European Central Bank (2005) Consolidation and diversification in the euro area banking sector. ECB Monthly Bulletin, pp 79–87
Federal Deposit Insurance Corporation and Bank of England (2012) Resolving globally active, systemically important, financial institutions (10 Dec 2012)
Financial Stability Board (2014) Structural banking reforms, cross-border consistencies and global financial stability implications. Report to the G20 leaders for the November 2014 summit (27 Oct 2014)
High-Level Expert Group on Reforming the Structure of the EU Banking Sector (2012) chaired by Erkki Liikanen, Final Report, Brussels (2 Oct 2012) (the 'Liikanen Report')
HM Treasury, Department for Business Innovation and Skills (BIS) (2012) Banking reform: towards the right structure
Independent Commission on Banking (ICB) (2011) Final Report, Recommendations (11 Sept 2011)
International Monetary Fund (IMF) (2010) Global financial stability report. Sovereigns, funding, and systemic liquidity. Available at http://www.imf.org/external/pubs/ft/gfsr/2010/02/pdf/text.pdf. Oct 2010
Joint Forum (2010) Review of the differentiated nature and scope of financial regulation, key issues and recommendations (January 2010). Available at http://www.bis.org/publ/joint24.pdf
Jones G (1993) British multinational banking 1830–1990. Oxford University Press, Oxford
Menoud V (2010) Financial conglomerates. Schulthesis, Zürich
National Bank of Belgium (2013) Structural banking reforms in Belgium: final report. Available at http://www.nbb.be/doc/ts/publications/NBBReport/2013/StructuralBankingReformsEN.pdf. Jul 2013
PWC (2014) Asset management 2020: a brave new world. Available at http://www.pwc.com/assetmanagement
Randell C (2011) The great British banking experiment: will the restructuring of UK banking show us how to resolve G-SIFIs? Paper prepared for the LSE Financial Markets Group Conference 'Banking Structure, Regulation and Competition', 25 Nov 2011
Snider (2013) The new crowded derivatives trade. Real Clear Markets. Available at http://www.realclearmarkets.com/articles/2013/06/14/the_new_crowded_derivatives_trade_100401.html
Thiessen R (2012) Are EU banks safe?. Eleven International Publishing, The Hague
Tripartite Group of Bank, Securities and Insurance Regulators (1995) The supervision of financial conglomerates. BIS, Basel